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DEPARTMENT OF AUDITOR-CONTROLLER

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January 7, 2004

TO: Supervisor Don Knabe, Chairman
Supervisor Gloria Molina
Supervisor Yvonne Brathwaite Burke
Supervisor Zev Yaroslavsky
Supervisor Michael D. Antonovich

FROM: J. Tyler McCauley
Auditor-Controller

SUBJECT: **AGUA DULCE MELLO-ROOS AUDIT (COMMUNITY FACILITIES DISTRICT NO. 6)**

We have conducted an audit of the Agua Dulce Mello-Roos Acquisition Fund (Community Facilities District (CFD) No. 6). We conducted the audit at the request of the Fifth Supervisorial District. The purpose of our audit was to review various concerns of a group of Sierra Colony Ranch residents and the management of the privately held water company that serves the development. These concerns focused primarily on the appropriateness of reimbursements to the developer from the Mello-Roos Acquisition Fund for expenditures the developer incurred in completing a water system.

The residents also alleged a number of improper financial transactions by the former management of the water company. These allegations are the subject of a Los Angeles County Sheriff Department investigation. We did not review these allegations because they are not related to either the Mello-Roos Fund or to the CFD.

BACKGROUND

On October 24, 1991, the Board of Supervisors adopted a Resolution establishing CFD No. 6. CFD No. 6 covers two development sites in the Agua Dulce area known as the Sierra Colony Ranch, also known as Improvement Area A, and Rio Dulce Ranch, also known as Improvement Area B. Improvement Area A consisted of two phases, Phase I and II. In January 1993, bonds in the amounts of $4.7 million and $2.0 million were issued for Phase I of Improvement Area A and Improvement Area B, respectively. No bond was ever issued for Phase II of Improvement Area A, property that currently contains a vineyard and winery.

METHODOLOGY

We interviewed staff from the Department of Public Works (DPW), Department of Regional Planning (DRP), Treasurer and Tax Collector (TTC) and County Counsel, and reviewed applicable documents including reimbursements from the Fund to the developer. At the request of the Fifth Supervisorial District, we also met with a number of residents and the water company management. Finally, we met with representatives from the developer, Watt Land, Inc., including Ray Watt.

REVIEW SUMMARY

DPW reimbursed the developer approximately $1.3 million from the Mello-Roos for expenditures the developer incurred related to the water system. DPW did not inspect the water system prior to authorizing reimbursement because they are not responsible for inspecting private utility systems. In this case, the water company, which at the time was both owned and managed by the developer, was responsible for inspecting and accepting the water system. We found that $313,000 which the residents believed were spent on improvements to pre-existing wells actually represented the developer's valuation of the wells. The developer stated he did not make any improvements to Well Number 2 to make it operational and we confirmed, based on a review of the available documentation, that he was not reimbursed for any such expenditures through the Mello-Roos. The determination as to the reasonableness of this valuation will require additional research, in conjunction with DPW and County Counsel. If the developer's valuation exceeds a reasonable valuation, we will recommend the developer return the difference to the Mello-Roos fund. We will provide your Board with a report on this issue within the next 30 days.

We also found there is a mechanism to tax the undeveloped land in Phase II (the vineyard and winery) should the registered voters and landowners approve such a change. Finally, we identified current refundable advances totaling $32,431 which the developer should return to the Mello-Roos fund.

These and other findings are discussed in more detail below.

Inspection

DPW reimbursed the developer approximately $1.3 million from the Mello-Roos for expenditures the developer incurred related to the water system. DPW did not inspect the water system prior to authorizing reimbursement because they are not responsible for inspecting private utility systems. Rather, the water company, which at the time was both owned and managed by the developer, was responsible for inspecting and accepting the water system. However, for purposes of requesting reimbursement from Mello-Roos, this acceptance of the water system by a related party appears to constitute a conflict of interest. It is noteworthy that under Board policy effective January 1994, expenditures related to this water system would not have been eligible as the water system does not have a regional benefit.

Improvements to Pre-Existing Wells

Of the $1.3 million, the residents have questioned how $313,000 related to two pre-existing wells (Well Number 1 and Number 2) was spent, as Well Number 2 has never been operational. DPW staff who reviewed all related documentation stated these funds appeared to represent a reimbursement for improvements to the wells. However, the developer stated that the $313,000 represented the value of the wells by estimating costs that would be incurred if two new wells with the same specifications were built. The Mello-Roos statute allows for the purchase by the CFD of pre-existing facilities. However, DPW stated that had it known the documentation was a valuation, it would not have authorized reimbursement from the Mello-Roos because the valuation submitted only considered the costs of drilling the wells themselves and not the wells' actual production. The determination as to whether the developer's valuation is reasonable will require additional research, in conjunction with DPW and County Counsel. If the developer's valuation exceeds a reasonable valuation, we will recommend the developer return the difference to the Mello-Roos fund. We will provide your Board with a report on this issue within the next 30 days.

The developer stated he did not make any improvements to Well Number 2, and based on our review of the available documentation, he was not reimbursed for any such expenditures through Mello-Roos.

Bond Repayment Method

The residents also stated that they are paying all of the Mello-Roos special tax resulting from the bond issuance, and that some tax should be allocated to the vineyard and winery, in Phase II. We found that the method for calculating the special tax requires that special taxes are first levied on the developed properties (i.e., Sierra Colony Ranch) and only levied on undeveloped properties (i.e., the vineyard and winery) if necessary to meet the special tax requirement. The special taxes that are levied on the developed properties are sufficient to meet the special tax requirement. Accordingly, undeveloped properties in Phase II, including the vineyard and winery, are not levied any taxes. TTC stated that a change in the method to include taxing the undeveloped property would require a petition by at least 25 percent of the registered voters in the improvement area (Phases I & II). However, if persons who individually or collectively own 50 percent or more of the acreage in the improvement area subsequently protest the change, the change may not be implemented. It is noteworthy that the undeveloped land (Phase II - the vineyard and winery) covers more acreage than the developed property (Phase I.)

Financial Oversight

We also noted that the DPW authorized reimbursement of approximately $110,000 from the CFD to the developer for refundable advances made to Southern California Edison (SCE). Refundable deposits and advances do not represent actual expenditures and should not be eligible for reimbursement from Mello-Roos. The developer provided us

documentation from SCE which showed SCE had retained a portion of the $110,000 advance to offset related costs and had refunded to the developer $32,431 to date. The developer should return the refunds it has received to the Mello-Roos fund.

REVIEW OF REPORT

We thank County Counsel, DPW, DRP and TTC management and staff for their cooperation and assistance during our review. We reviewed our report with DPW, TTC, County Counsel and the developer.

If you have any questions, please contact me or have your staff contact DeWitt Roberts at (626) 293-1101.

JTM:DR:JK
Attachments

c: David E. Janssen, Chief Administrative Officer
Lari Sheehan, Assistant Administrative Officer
Lloyd W. Pellman, County Counsel
Steve Cooley, District Attorney
James A. Noyes, Director, Department of Public Works
James Hartl, Director, Department of Regional Planning
Leroy D. Baca, Sheriff
Mark J. Saladino, Treasurer and Tax Collector
Violet Varona-Lukens, Executive Officer
Mello-Roos Task Force
Audit Committee (6)
Watt Land, Inc.
Public Information Officer

Los Angeles County

Agua Dulce Mello-Roos Audit
(Community Facilities District No. 6)

January 2004

Prepared by:

Department of Auditor-Controller

Agua Dulce Mello Roos Audit
(Community Facilities District No. 6)

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Agua Dulce Mello-Roos Audit
(Community Facilities District No. 6)

BACKGROUND

On October 24, 1991, the Board of Supervisors adopted a Resolution establishing Community Facilities District No. 6 (CFD No. 6). CFD No. 6 covers two development sites in the Agua Dulce area known as the Sierra Colony Ranch, also known as Improvement Area A, and Rio Dulce Ranch, also known as Improvement Area B. Improvement Area A consisted of two phases, Phase I and II.

In October 1992, the Board adopted a Funding and Acquisition Agreement (F&AA), which established terms and conditions for the acquisition and/or construction of the facilities for Improvement Areas A and B. In January 1993, bonds in the amounts of $4.7 million and $2.0 million were issued for Phase I of Improvement Area A and Improvement Area B, respectively. The actual proceeds from the bonds were approximately $4.6 million and $1.9 million, respectively. Of these amounts, the F&AA designated approximately $3.5 million to finance various public improvements including water systems in Phase I of Improvement Area A (see Attachment I). Approximately $1.6 million for Improvement Area B was designated to finance the acquisition of a school site for the Agua Dulce-Soledad Union School District. No bond was ever issued for Phase II of Improvement Area A. The following table summarizes the CFD No. 6 bonds.

Table I
CFD No. 6 - Summary of Bonds

	Sierra Colony Ranch		**Rio Dulce Ranch**
	Improvement Area A		Improvement Area B
	Phase I	Phase II	
Bond proceeds	$4.6 million	Bonds not issued	$1.9 million
Acquisition fund	$3.5 million		$1.6 million
Bond issuance/reserve	$1.1 million		$0.3 million
Reimbursements to developer	$3.3 million		$1.6 million
Homes planned	61	84	690
Homes built	61	0 [1]	0 [2]

[1] No residential units were built. The developer built and operates a vineyard and winery instead.
[2] The area was never developed due to a lack of water, and the bonds consequently defaulted.

The developer, Watt Land, Inc., initially planned to build up to 145 residential units in Sierra Colony Ranch, Improvement Area A (61 in Phase I and 84 in Phase II), and up to 690 units in the Rio Dulce Ranch, Improvement Area B. However, the developer did not develop Phase II of Improvement Area A or any of Improvement Area B. Currently, only Phase I of Improvement Area A contains residential units. Phase II of Improvement Area A currently contains a vineyard and winery, owned in part by Ray Watt. Improvement Area B is currently vacant and contains no developed properties.

SCOPE/OBJECTIVES

We conducted the audit at the request of the Fifth Supervisorial District. The purpose of our audit was to review various concerns of a group of Sierra Colony Ranch residents and the management of the privately held water company that serves the development. These concerns focused primarily on the appropriateness of reimbursements to the developer from the Mello-Roos Fund for expenditures the developer incurred in completing a water system. Our review focused on the Area A Fund because the concerns relate only to this area.

The residents also alleged a number of improper financial transactions by the former management of the water company. These allegations are the subject of a Los Angeles County Sheriff Department investigation. We did not review these allegations because they are not related to either the Mello-Roos Fund or to the CFD.

METHODOLOGY

We interviewed staff from the Department of Public Works (DPW), Department of Regional Planning (DRP), Treasurer and Tax Collector (TTC) and County Counsel, and reviewed applicable documents including reimbursements from the Fund to the developer. At the request of the Fifth Supervisorial District, we also met with a number of residents and the water company management. Finally, we met with representatives from Watt Land, Inc., including Ray Watt.

COMMENTS AND RECOMMENDATIONS

Community Concerns

Water System

The residents stated that the County reimbursed the developer approximately $1.3 million from the Mello-Roos Fund for expenditures the developer incurred in constructing a water system, but that the County did not properly inspect the system to determine if it worked, prior to authorizing the reimbursements. The residents also stated that, as part of the construction of the water system, the developer did not construct new wells, as stated in the F&AA, but rather simply made improvements to wells that existed prior to the development. As a result, the residents stated the County reimbursed the developer for expenditures related to a prior-existing well (Well Number 2) that is not currently operating. Finally, the residents stated that the developer may have inappropriately used Mello-Roos funds received for work related to Phase I for improvements to Well Number 3, which is in Phase II, and is currently used exclusively by the vineyard and winery. (See Attachment II for a listing of the well numbers and their locations.)

Inspection

To supply water to the Sierra Colony Ranch development, the developer established a private water company (Sierra Paloma Valley (SPV) Mutual Water Company), which is not subject to the regulation or control of the California Public Utilities Commission (PUC). Prior to selling the homes, the developer owned all shares of the water company, but each homeowner became a shareholder upon purchase of his or her home. The water company is currently fully and mutually owned by homeowners. The developer, or his associates, managed the water company until the summer of 2002 when several residents assumed management.

DPW stated that it is not responsible for inspecting utility systems (i.e., electric, gas or water systems.) Rather, the company that owns the system is responsible for inspecting the construction of new facilities or systems and confirming the systems operate in conformance with applicable rules and regulations. DPW stated that in order to authorize reimbursement through Mello-Roos, it requests a statement from the utility company that the system is operational and accepted by the utility company. In this case, DPW authorized the reimbursement from the CFD to the developer for expenditures related to the water system, upon receipt of a written statement from the Secretary of the water company stating the water company accepted the water system for operation and maintenance. However, at the time, the developer both was the sole owner of, and managed, the water company. In fact, the Secretary of the water company who signed the written statement submitted to DPW was also the Chief Financial Officer of the development firm. We reviewed this issue with the developer who stated it is common practice for developers to both own and manage a private water company during the initial stages of development. However, the parties involved in this case were related, and for purposes of requesting reimbursement from Mello-Roos, this acceptance of the water system appears to constitute a conflict of interest.

DPW's authorization of the $1.3 million in reimbursements related to the water system occurred in the early 1990s. This was prior to revision of the Board's Mello-Roos Goals and Policies, effective January 1994, which require that public infrastructure improvements funded through Mello-Roos have a regional benefit. Under present Board policy, expenditures related to a water system that serves one development exclusively are not eligible for reimbursement from Mello-Roos.

Improvements/Construction of Wells

As stated earlier, the residents alleged that the developer did not construct new wells, as required in the F&AA, but simply made improvements to existing wells. As a result, the residents stated the County reimbursed the developer for expenditures related to a prior-existing well (Well Number 2) that is not operational.

Exhibits to the F&AA listed approximately $1.4 million in estimated expenditures related to the water system (i.e., installation of water lines, a storage tank and pump stations.) This total also included $313,000 for two "groundwater wells." The F&AA was vague

regarding the estimated use of the $313,000 (e.g., construction of new wells, improvements to existing wells, or valuation of existing wells.) Due to the fact that the F&AA was finalized over 10 years ago, we were not able to locate any additional documentation delineating the estimated use of the funds.

In March 1993, DPW authorized a reimbursement to the developer of $313,000 based on cost estimates, submitted by an environmental engineer, related to Well Number 1 and Number 2. Current DPW staff who reviewed all related documentation stated this cost estimate appears to represent improvements to the existing wells completed by the environmental engineer. However, in late December 2003, we met with representatives from Watt Land to review this issue. After speaking with the environmental engineer, the representatives stated that because Watt Land was transferring ownership of the wells to the SPV Water Company, the estimates were intended solely to establish the value of the wells by estimating the costs that would be incurred if new wells with the same specifications were drilled. The representatives stated that the estimates were not a cost estimate for establishing any work that was to be done on the wells. They stated they did not make any improvements to Well Number 2 and did not request any reimbursement for improvements to Well Number 2. Based on our review of the available documentation, the developer was not reimbursed through Mello-Roos for any expenditures related to improvements to Well Number 2. (In November 1993, DPW authorized reimbursement to the developer of $65,000 for a sanitary seal and other well equipment related to Well Number 1. Well Number 1 is operating.)

The documentation from the environmental engineer did not clearly state that it was a valuation. We contacted the environmental engineer who confirmed he prepared the cost estimates for valuation purposes.

The Mello-Roos statute allows for the purchase by the CFD of pre-existing facilities, in this case, the wells. However, DPW stated that, had it known the documentation from the environmental engineer was a valuation, it would not have authorized the reimbursement from Mello-Roos because the valuation submitted considered only the costs of drilling the well itself and not the well's actual production. The determination as to whether the reimbursements to the developer for the valuation of the wells are allowable will require additional research, in conjunction with DPW and County Counsel. If the developer's valuation exceeds a reasonable valuation, we will recommend the developer return the difference to the Mello-Roos fund. We will provide your Board with a report on this issue within the next 30 days.

Well Number 3

Due to the lack of sufficient documentation to support the great majority of expenditures for which DPW authorized the reimbursement to the developer (discussed further in the *Financial Oversight* section), we were unable to investigate whether the developer inappropriately used Mello-Roos Phase I improvement funds for Well Number 3, which is in Phase II, and is currently used exclusively by the vineyard and winery.

Shortage of Water

The residents stated that a new builder, not related to the original developer, should cease construction of the remaining homes in Sierra Colony Ranch Phase I because the water system is not producing a sufficient amount of water to meet the needs of the existing homes. The residents believe they would have sufficient water if Well Number 2 was operating.

DPW previously addressed this issue in May 2003. DPW stated that the County is unable to stop construction of the remaining homes because the water system's current production, based on statements from the management of the water company in April 2003, aligned with the County's assumptions in approving the development. The County had assumed an average daily consumption of 700 gallons per day, per dwelling (i.e., 200 gallons per day per capita, with an assumption of 3.5 residents per dwelling).

We met with the water company management in October 2003, and management stated that production had decreased approximately 50% from the April 2003 levels it disclosed to DPW. Although not certain of the exact reason(s) for the decline, management believes it is due to general deterioration of Well Number 1, caused by the lack of improvements initially made by the developer as well as deferred maintenance since being transferred to the water company. Management stated they believed the decrease in water production would be resolved if they had two operating wells, not one.

DPW stated that the water company is solely responsible for the maintenance and operation of its water system.

Rights to Aquifer

The residents stated that the developer's use of Well Number 3 (in Phase II) to water the vineyard is depleting the aquifer, which belongs solely to the water company and/or residents. We discussed this issue with County Counsel who stated this is a private water rights issue among all parties who pump water from the aquifer, and that these parties should review the issue with their respective legal counsel.

Bond Repayment Method

The residents stated that they are paying all of the Mello-Roos special tax resulting from the bond issuance, and that some tax should be allocated to the vineyard and winery, in Phase II.

We reviewed the Official Statement, 'Method of Apportionment of the Special Tax', which describes the manner in which the special tax is calculated. Based on this method, agreed upon by the County and the developer, a developed property is subject

to taxation first. If additional monies are needed to meet the special tax requirement after levying taxes on developed properties, up to the maximum tax requirement of $7,667 per the Assessor's Parcel, undeveloped and taxable public properties are subsequently taxed. Each home owner in Phase I is currently paying approximately $5,000 per year, which is less than the maximum of $7,667 per parcel. Per the Official Statement, a 'developed property' is defined as a taxable property for which a final tract map has been recorded and an 'undeveloped property' is any property not classified as developed. Within this CFD, only Phase I, where the homes are located, has been recorded with a final tract map.

TTC stated that taxes collected from developed properties are sufficient to meet the special tax requirement and therefore, undeveloped properties in Phase II including the vineyard and winery, are not levied any taxes.

TTC stated that a change in the method to include taxing the undeveloped property would require a petition by at least 25 percent of the registered voters in the improvement area (Phases I & II). However, if persons who individually or collectively own 50 percent or more of the acreage in the improvement area subsequently protest the change, the change may not be implemented. It is noteworthy that the undeveloped land (Phase II - the vineyard and winery) covers more acreage than the developed property (Phase I.)

Financial Oversight

Between January 1993 and December 1994, DPW authorized the reimbursement to the developer of approximately $3.3 million. We reviewed the documentation supporting the developer's reimbursement requests to determine if the requests were supported by appropriate documentation (e.g., copies of contracts or invoices and cancelled checks, etc.). Of the $3.3 million in reimbursements, only $400,000 was adequately supported. Of the remaining $2.9 million, we noted the following:

- Approximately $2.5 million in reimbursements was supported only by the developer's internal cost reports. In general, these cost reports listed the public infrastructure improvements to be completed (e.g., grading, paving, drainage, etc.) and an associated cost. However, this documentation is insufficient to support a reimbursement because the actual costs the developer incurred may have been different than those included on the cost report, and the cost reports did not indicate that an actual outlay of funds had occurred. We attempted to obtain additional supporting documentation from the developer, but were unsuccessful. The developer stated that the transactions occurred approximately 10 years ago, and he did not maintain supporting documentation for this length of time.

  DPW stated that their standard practice is to authorize reimbursement only after confirming the developer made the related improvements. We reviewed DPW's inspection logs and found that an inspector was on-site on a daily basis,

documenting the detailed progress of improvements. Accordingly, based on this practice, it appears likely the developer properly completed the vast majority of improvements for which he requested reimbursement.

- DPW authorized the reimbursement to the developer of approximately $110,000 for refundable advances made to Southern California Edison (SCE). As discussed in our audit of the La Vina Mello-Roos Fund, dated July 9, 2003, refundable deposits and advances do not represent actual expenditures and should not be eligible for reimbursement from Mello-Roos. We reviewed this issue with the developer who provided documentation from SCE, dated November 24, 2003, that stated SCE had retained approximately $43,621 to offset related costs, had refunded $32,431 to the developer, to date, and was investigating the status of $7,099. This left a balance of $26,429 still subject to refund. After SCE has dispositioned the $7,099 which it is investigating, the developer, in conjunction with DPW and TTC, should return the refunds it has received to the CFD and assign the balance still subject to refund, to the CFD.

Recommendation

1. **In conjunction with DPW and TTC, the developer should return to the CFD the refunds it has received, and assign to the CFD the balance still subject to refund.**

Attachment I

Agua Dulce Mello-Roos Audit
(Community Facilities District No. 6)

Estimated & Actual Reimbursements

Facility Category	Estimated Reimbursements	Actual Reimbursements	Difference
Road Improvements	$763,000	$1,156,302	$(393,302)
Sewer Lines	272,000	196,525	75,475
Water System[1] Improvements	1,405,000	1,272,556	132,444
Drainage Improvements	215,000	201,617	13,383
Utility Improvements	290,000	109,581	180,419
School Site	500,000	342,000	158,000
Total	**$3,445,000**	**$3,278,581**	**$166,419**[2]

[1]The Water System Improvements included a 700,000-gallon regional storage tank, pump stations, water lines, and water wells.

[2]The difference of $166,419 was transferred to a redemption account, used for reducing the bond liability.

ATTACHMENT II

Agua Dulce Mello-Roos Audit
(Community Facilities District No. 6)

Locations of the wells

- Well Number 1 – Located near the intersection of Sweetwater Drive & Euler Road.
- Well Number 2 – Located adjacent to Caprock Road.
- Well Number 3 – Within the boundaries of vineyard and winery (Improvement Area A – Phase II)